DOW THEORY LETTERS INC.

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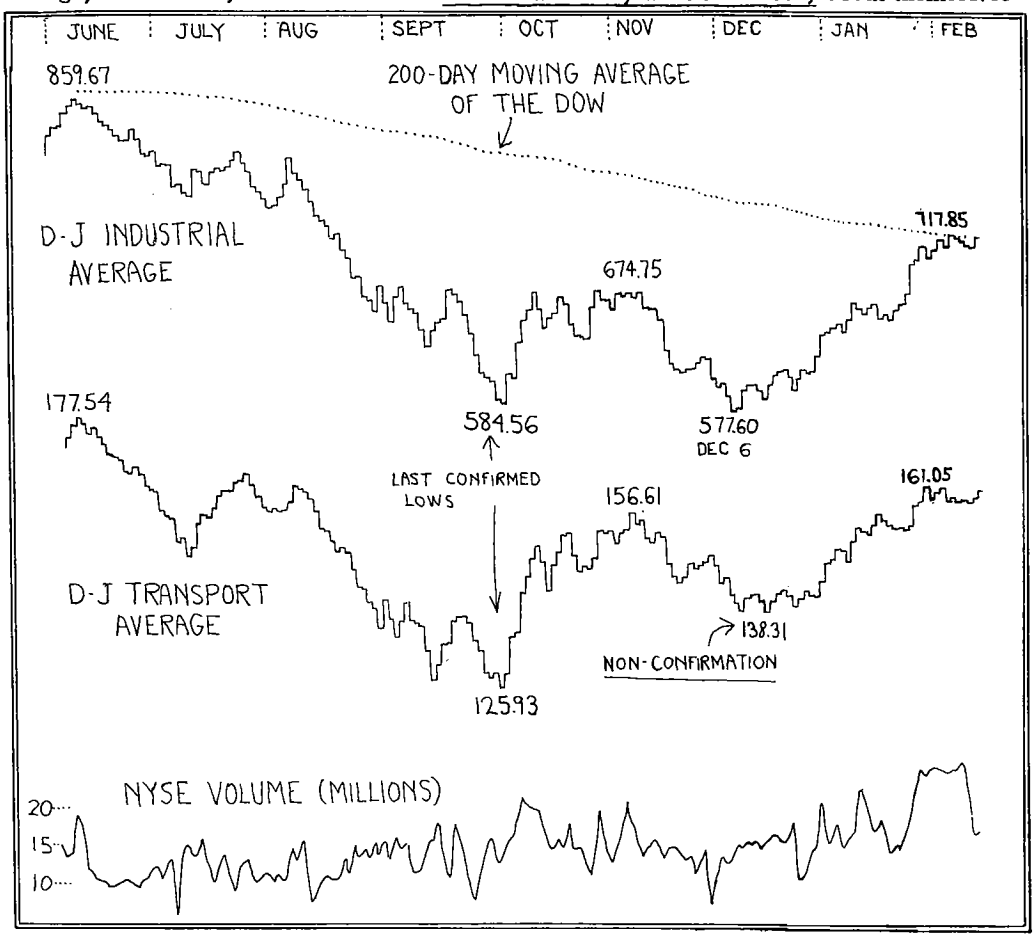
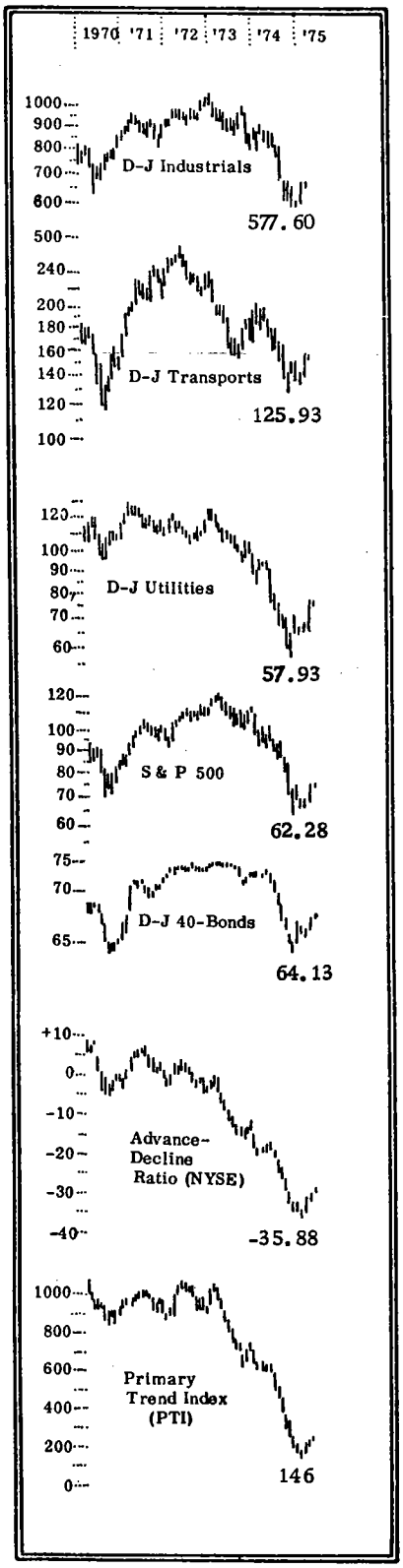
"Believe nothing merely because you are told it." Alan Watts.

THE PICTURE: Many men talk proudly (usually just after the New Year) about how much they have "changed." But a man doesn't change in the sense that he becomes something different. If he makes any emotional progress here on earth, it is that he simply learns to become more himself. The neurotic, the psychotic, the man riddled with anxieties, he may change in the eyes of his friends by becoming "more normal" or "better" or whatever one wants to call it. Actually, what the man may have done is rid himself of the false assumptions, the crippling fears or the misconceptions that have kept him from discovering his authentic nature. The great psychiatrist, Carl Jung, once stated that our only mission in life is "... to find ourselves and live accordingly."

Human nature doesn't change either. Taken as a whole, human nature today is about the same as it was during the time of the Roman Empire or the days of ancient Egypt. We have learned much more, but emotionally men respond in much the same way now as they did then. Two emotions rule man, Love and fear (opposites), and the great struggle is to rid oneself of the latter so that one can live by the former. This is what the great Teacher of Nazareth tried to tell us two thousand years ago. Few of us have learned his lessons.

Man is stubborn and proud. Man doesn't want to become more himself, he doesn't want to go through the humbling experience of seeing himself as he really is (which would represent true change). In the end, it seems that men believe what they want to believe, about themselves





 (especially), about their friends, about the world, and even about the stock market.

For instance, it is obvious that a severe recession is now in progress. If you don't believe it, read your local newspaper or Time magazine or Newsweek or watch your favorite TV newscast. On every hand we are told that the times are terrible — and getting worse. That hardly allows for a bull market in stocks, reasons the news media, so why mention the "bull market" at all — or why mention the fact that Dow's Theory has rendered a bull signal? Who wants to read that kind of idiotic news? It simply doesn't jibe with the average readers' perception of what is happening. The recession, the unemployment, the welfare lines, they are the REAL NEWS, not the damn bull market on Wall Street (besides, the average man is no longer in stocks, so why taunt him with "bull markets" and rising stock percentages and other nonsense?).

Yet, even the optimists are subject to pride of opinion. I have read any number of bullish advisories (many having turned bullish over the last week or so) who are now providing readers with precise "upside targets" for this advance, augmented by exact reaction points, and so forth and so on. All of which is sheer nonsense, since (as I have written repreatedly) neither the extent nor the duration of a primary advance can be predicted in advance. Thus, one service informed readers that it was putting out shorts in the 690 area, an area that was supposed to represent "the upper limit" for the Dow. A number of the bearish advisories are calling this an upward "blow-off," and as far as I am concerned, they can label it an aardvark or a matzo ball or anything they like. My friend at the Phillips Report put it as well as any when he said last week, "If this isn't a bull market, it will do until the real thing comes along."

In the last Letter I wrote that I have never seen a bona fide Dow Theory bull signal as ignored, as denigrated, as explained away as this one. Men believe what they want to believe. But it is well to remember that Dow's Theory has been around for a long time. It has been attacked over and over again, yet it has outlasted all its detractors — generations of them. And I have no doubt that the Theory will be alive and well, long after today's "experts" and soothsayers have left Wall Street.

So let's move on to the market. Art Merrill of Merrill Analysis notes that since 1890 there have been just eight rallies greater than 23% (by February 6, 1975 the Dow was up 24.2%, while Value Lines' unweighted Average was up 31%). "In two of these rallies," says Merrill, "the bear continued down, after the rally, to lower depths. However, in six of the eight, the rally turned out to be the first upward swing in a new bull market."

The power of the initial upward thrust of this bull market can only be described as spectacular. In the last Letter I discussed the extraordinary power of the actual bull signal of January 27. The signal came on simultaneous penetrations of the two Averages (Industrials and Transports) above their previous November peaks — on the greatest single day of volume in stock market history. After this kind of inauguration, it would not be unwarranted to be ready for the "unexpected" from this bull market on the upside. So far, we have received just that. The upside action has been spectacular.

On January 31 the Dow pushed effortlessly above the 700 level, thereby flabbergasting those who insisted that "690 is the ceiling." On February 5 the Dow rallied above its 200-day moving average, an index that now stands at 712 (see page 1 chart).

Technically, the first penetration of the Dow above its 200-day moving average (MA) is an event of great importance. The importance is heightened when the penetration comes following a bear market bottom and in the face of widespread pessimistic sentiment. The usual action following the Dow's initial penetration of the 200-day MA is a period of hesitancy or even a reaction below the MA again. There will then be a period during which the 200-day MA flattens out (note on page 1 that the MA is still declining). When the Dow pushes above the MA for the second time we have a most bullish situation. This is the "normal" sequence, but as we know, the market seldom follows the perfect script. What will it mean if the Dow simply rallies above the MA and stays above it? In that case, I would say that we would be seeing a tremendously powerful bull move. We saw this kind of action in 1958 when the Dow pushed above the MA, came back to test it, then headed up again without ever looking back.

The rationale behind an upward penetration of the 200-day MA is worth discussing at this time. The Dow Industrial Average is representative of 30 of the best run, best financed blue chip corporations in America. These are the kind of stocks that are bought (after the most careful analysis) by informed investors. Informed investors (often called "the big money") set the trend of the market. And they tend to be right over any reasonable length of time.

What is the market telling us when the Dow pushes over its own 200-day MA (particularly when such action comes in the face of widespread pessimism regarding the economy)? The market is telling us that in the considered opinion of informed investors, the 30 Dow stocks (on average) are worth more now than at any time during the average of the last 200 days (or a period of around six months). This "reading" is underscored if (1) the trend of the 200-day MA is rising, and (2) the Dow continues to hold above its rising 200-day MA.

As to the current situation, it will take time for that sequence to materialize. But I believe we should see it during the weeks ahead. In the meantime, we have had our first signal, a penetration by the Dow above the 200-day MA.

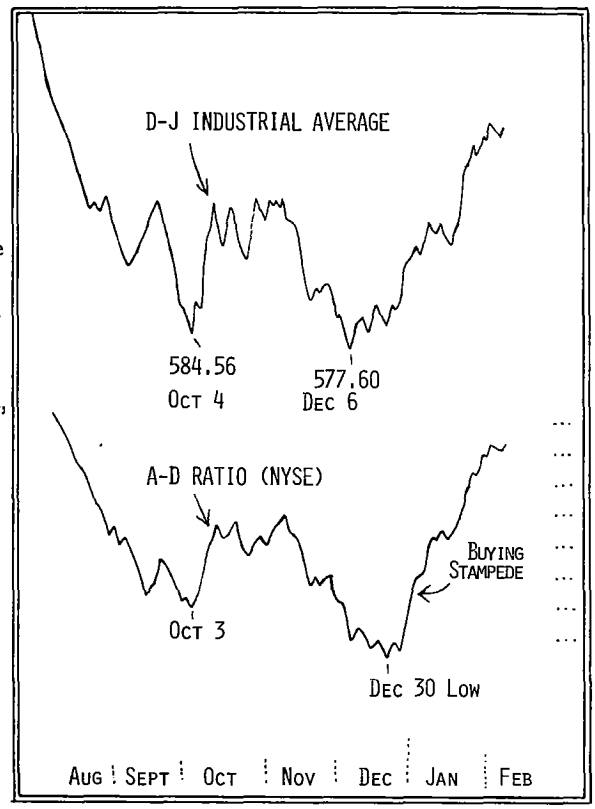
NEAR-TERM: Many leading analysts (and undoubtedly many of my readers) are worried about the possibility of the market's "just churning and rolling over into a broad collapse." The great buying stampede that has sent the advance-decline ratio steadily higher since its December 30, 1974 low is into its 34th day. Volume has been huge of late as the battle between those who think stocks are a buy and those who take this as a golden opportunity to "dump 'em" goes on. The record volume is simply technical proof of the magnitude of the differences of opinion.

The power of this buying stampede is beyond any seen since World War II (see next section of this Letter), but the duration is far from a record. The record for number of days in an investment stampede was set during December 5, 1960 to April 11, 1961 when a single buying stampede lasted for 93 trading days.

The historical records are also unanimous in showing that no buying stampede has been immediately followed by a major decline. The kind of tremendous reinvestment interest that produces a buying stampede is not reversed in a day or a week. I expect continued recoveries (regardless of temporary dips) in the Industrial Average as long as the A-D ratio moves higher. The signs of trouble will come with non-confirmations, but as I said before, the first trouble will probably be of minor or intermediate, rather than of major proportions.

From the standpoint of Dow's Theory and the Averages, the last upside points of importance were the recovery highs of Transports at 161.05 (January 29) and of Industrials at 717.85 (February 6). If the two Averages move above those levels, this rally (following a period of consolidation) will have a new lease on life. Persistent failure by Transports to hurdle the 161.05 could indicate a developing correction.

PRICE AND BREADTH: I hope this particular Letter isn't too technical for my readers, but it's your money you're dealing with, and only knowledge will provide you with the tools to handle your hard-earned money correctly. Only knowledge will provide you with the discipline to buy when your insides are screaming "Sell," and to sell when everything you read and feel says "Buy."



It was in Letter 619 that I first used the label "buying stampede" to describe the all-encompassing upside action of this market. I want to discuss the remarkable phenomenon of the breadth stampede in more detail now. During past primary bull markets, we witnessed a number of these investment stampedes (or "breadth stampedes" as I sometimes refer to them). I term any steady rise in the A-D ratio lasting a few weeks or more as the start of a potential buying stampede. If the move advances the A-D ratio 5 points or more (as this one has now done), I definitely label it an investment stampede. The stampede is taken to end with the first drop in the A-D ratio of one full point or more. Since December 31, 1974 we have had no drop in the A-D worth talking about, a truly powerful performance! (See chart).

The record of investment stampedes during bull markets is clear enough. Following the end of all stampedes (in other words, following the first reaction), the Dow has turned up and advanced to new highs. If the A-D ratio also followed to new recovery highs, it signalled a new phase of the investment stampede, and often an important one. On the other hand, if the A-D ratio refused to confirm new recovery highs in the Dow, a further and usually more substantial correction was due.

During primary bear markets the action is usually more difficult to interpret. Breadth stampedes can occur in primary bear markets (such as the one that appeared during August-October, 1974), but any non-confirmation at the peaks is likely to signal the end of the entire movement and a new decline to fresh bear market lows.

I spent the weekend going over my chart of the various buying stampedes in history. I can't review them all here, but suffice it to say that the 1975 stampede is historic. The only post-War stampede that compares with it in sheer power is the one that was seen during October to December, 1962 (it lasted 30 trading days). During that period the A-D ratio gained a total of 6.27 points before it reacted. The 1962 stampede showed an average daily gain in the A-D ratio of .209 points, and it was the most powerful stampede ever seen up to that time. Stampedes have since appeared in 1968, 1970, 1972 and 1973. None of them equalled the 1962 affair in power.

Then we come to the latest investment stampede that began on December 31, 1974. The stampede began at minus 36.52 on my chart. As of this writing, we have had 31 days of upside action. And as of this writing, the A-D ratio has registered a peak of minus 29.62 (on February 6). This means that we have gained 6.90 points for the A-D so far in the stampede or an average of .222 points per day, an average daily gain greater than 1962. Nothing like the upside action of 1975 has been seen since World War II.

I don't pass myself off as a crystal ball type of analyst or as the "Great Predictor." But I do think that historic comparisons can be instructive. The 1962 low for the Dow was 535.76. The 1962 breadth stampede kicked off a bull market advance that ultimately drove the Dow to the February, 1966 peak of 995.15. That was a rise for the Dow of 86%. Will history repeat? Maybe, maybe not, but it is always wise to question our preconceived notions.

Every investment advisory or financial magazine is now telling us about the catastrophic condition of the nation, its currency, its debt. I don't disagree; I never have. But the TIMING, that's the question, the timing. "When" is what they don't tell us. Suppose we have an important bull market first? Suppose the average stock triples before the next bear market? It's the old story, the market always does what it is supposed to — BUT NEVER WHEN. Or to put it another way: I can make millions trading any single stock on the Board. If you just tell me WHEN the stock is going to rally and WHEN it's going to decline.

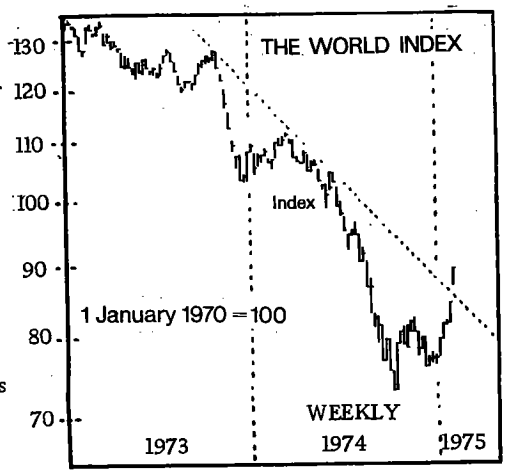
TECHNICAL STUDIES: Few students realize how much bad news was discounted by the market during the last few years. Yet it is crucial to understand fully the thesis that the market discounts, that it looks ahead. I have just completed a study of the Dow in terms of advancing and declining days for the year. The study shows that in 1974 the Dow Industrials declined on 144 out of the 253 trading sessions. This was the highest total of daily declines since 1946, a year when the Dow declined on 145 out of a total of 281 trading sessions. In 1941 we had an extraordinary 162 down days for the Dow out of 301 trading days. The all-time record was 1931's 177 out of 300 trading days.

Here's how the total of down days per year work out in terms of percentages. 1931 showed 59% of declining days, 1941 produced 54%, 1946 had 51.6% and 1974 came through with 56.9%. Thus, the amazing story is that 1974 produced the second biggest percentage of daily Dow declines in history, surpassed only by 1931. In other words, the year 1974 was one of fantastic downside compression. That action discounted one hell of a lot of forthcoming bad news.

What happened following the previous "bad" Dow years? Following 1931, the Dow bottomed at the famous 1932 low of 41.22, a low that was never seen again. After 1941 the Dow dropped to the 1942 bear market low of 92.92 (April), and that low was never seen again. In 1946 the Dow dropped to a low of 163.12 (October). Despite three more years of rally and decline, the 163.12 served as a base from which the great bull market of 1949-1966 was launched. Actually, in June, 1949 the 1946 low of 163.11 was penetrated by two points to produce the famous 1949 Dow low of 161.60, a low that has never been revisited. My conclusion: The great downside market compression of 1974 suggests that the 1974 Dow low of 577.60 is a most important level, perhaps one of historic significance.

WHAT'S HAPPENING? Question: Russell, pull your nose out of the charts and put the Dow Theory down for a minute. Now I'm going to ask you, what do you think is happening? Go on, talk off the cuff. Answer: OK, here goes. My friends, Jim Dines and Tom Holt, and others are predicting a great depression, and they may be right. But I don't think we'll see the depression this year. I think the world got "too prepared" for the depression. In a recent poll, 46% of Americans interviewed expected a depression. That many people usually aren't right on whether the sun's out or not.

Study this chart put out by Capital International Perspective. It's their World Index of all the major markets. The world's stock market exploded last month, and as the International Bank Credit Analyst stated in its latest report, "On almost a worldwide basis, classic elements of a boom build-up are developing.... Moreover, the authorities in virtually all the Western countries are aggressively reflating."



I personally think we are going to see inflation again. Sure, auto and appliance buyers are getting rebates (meaning lower prices) today, but in general prices are not breaking, and I don't think they will in the period ahead. People are not starving despite unemployment, and as time goes on and nothing "terrible" develops, I think Americans are going to become somewhat optimistic again. Then the inflation will rekindle in earnest (maybe in late-1975 or '76). And I think that people are going to protect themselves increasingly in the one area that is fully deflated, the stock market. This is probably the meaning of the huge NYSE volume recently. It represents the return to deflated values.

I think we are going to see huge market volume, new highs in velocity of money turnover, perhaps a bull market that will ultimately end with a spearpoint top. In such an atmosphere, gold shares may well go with the industrial shares as everyone seeks to protect themselves against inflation. And the fact is that you can buy assets in common stocks today at 20¢ and 30¢ on the dollar. In terms of replacement costs and as assets, stocks are still great bargains.

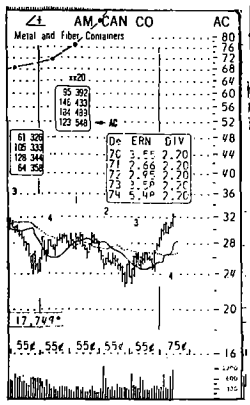
The huge deficits being built into the national budget now will probably light the fuse well after stimulation in the economy is needed. I believe that what we are seeing today is not a rally in a bear market (as so many analysts are claiming) but another real cyclical rise, a final expansion of business before the whole thing comes apart at the seams.

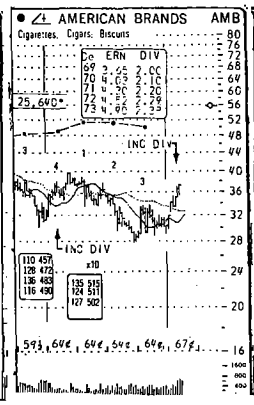
And that is just what I think the tremendous primary bull signal of January 27 was telling us. It was saying, "No, the end is not here in 1975. It's going to hold together through another cycle." Personally, I think they are going to get the economy rolling once more before the time-bomb of deficits and debt ignites. The country's got one more super-inflationary "whoosh" in it, and then it's "into the storm cellars for us all."

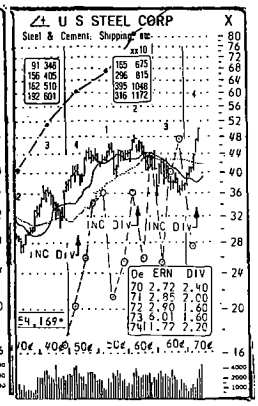
At any rate, those are my suspicions. And I might as well say something here about the many (and often well-meaning) "survival" tactics and plans being advanced by various publications. Frankly, I'm not at all sold on this approach. After mulling it over for months, I've come to the conclusion that we're going to have two bum choices when this thing finally hits the fan: (1) Pack up, take your gold and silver coins (forget about the shares), and set sail for another land (and hope that the new paradise will stay afloat), or (2) Stay here in America the Beautiful and sweat out the collapse of the greatest mountain of debt in world history.

Obviously, I don't know what's going to be left. But those who think that gold shares or T-bills or even gold coins are THE answer to survival are kidding themselves. We could see anarchy, we could watch as Big Brother grabs it all, we could have a totally new system. And all the coins and dried black-eyed peas that you've buried behind the old oak tree wouldn't help you a whit. As for gold shares, they'll represent claims on mines that probably won't even be operating amid the chaos, but all that is another story, and I'll go into it in more detail when the time is right. What will I do, personally? I'm going to stay right here, and try to help put Humpty Dumpty together again.

In the meantime, we have to live, and life goes on. I think we are going to have one more expansionary cycle ahead, so take it easy, take it one cycle at a time, and remember, the powers above don't give any man a problem beyond his ability to solve. Those same powers are not trying to destroy us, they're trying to advance us toward something that ultimately resembles truth and right. And that's what I believe it's all about.

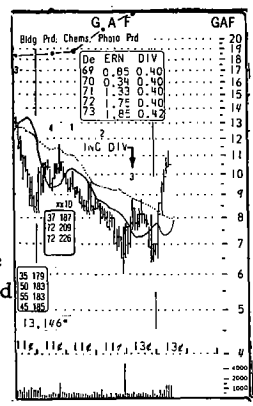


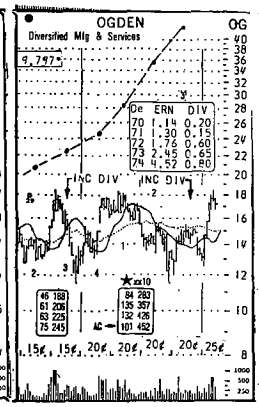


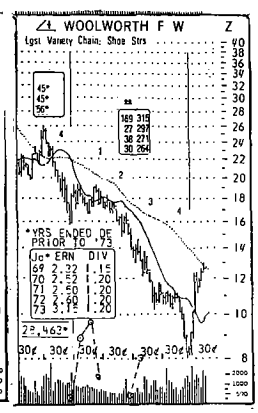


STOCKS: An article in the February 10 Wall Street Journal pointed to softening of steel demand in certain lines, and profit-taking hit a number of the steels. This kind of selling on the news is hardly my idea of informed distribution, but it does give subscribers a chance to buy a few of the steels mentioned in the last report, particularly US Steel, which I like (since it is the leader). Note on the chart from Quote (PO Box 213, Wichita, KS 67201) that US has spiked up from its 36 low of a few months ago. Note also that the 10-week moving average (solid black line) is rising but has not yet bettered the 200-day MA (dotted line). If and when we do get such a crossing, it will be a strongly bullish signal for US Steel, and at that point I think we could have a major move in the whole steel group.

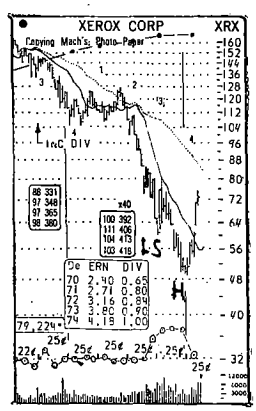
Referring to the US Steel chart (monthly) in the last report, it is well to note that on the week ending February 7 Big Steel hit 50, thereby bettering all peaks going back to 1967. With the market consolidating and the Journal scaring would-be steel buyers, this should provide readers with an advantageous area in which to buy US Steel and perhaps Armco, which I also like. As this is written, US Steel has backed off into the 47 area where it should consolidate. The next rally in Steel, passing 50, should be the real McCoy.







I will repeat again that I like the values and the market action in two other Dow stocks, American Brands, American Can. Both are showing rising earnings trends and both have good dividends that are very well covered. I include the charts here (all small charts courtesy of Quote) of Ogden, Lucky Stores and Woolworth, three stocks that have been previously recommended at lower prices. Ogden shows a rather remarkable pattern with a triple top at 18. The stock has been consolidating since its last major move from 13 to 18, but I feel that it is getting ready to move out of the 12-18 rectangle pattern where it has been basing for over a year. Once out of the 18 area, Ogden (which earned $4.52 for the last four quarters and pays 25¢ quarterly should move well into the 20's.



Lucky Stores has boomed out of the 7-9 base and moved up to 12, but like so many other stocks, it now needs to back off and consolidate. I would buy the stock anew on any decline to the 10-11 area. Woolworth, which many of us bought around 8, is now up over 50%, and I have heard earnings estimates of over $2 for Woolworth for the coming year. The dividend seems secure, and a friend figured that at the recent price for the stock, each store owned by Woolworth was valued at around $60,000. Is that a classic case of undervaluation!

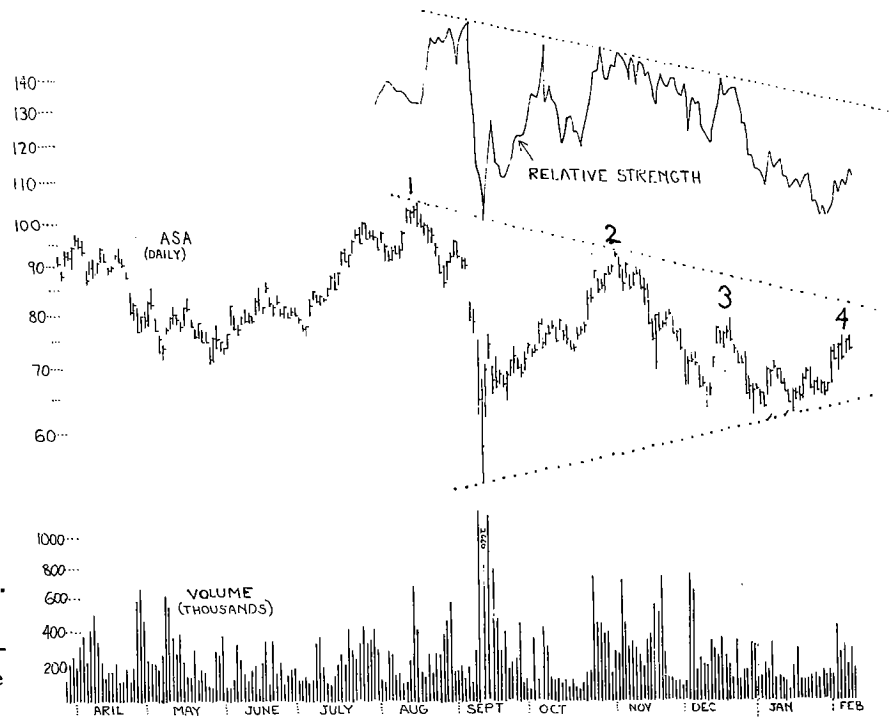
One point I want to make here is that many stocks such as GAF (see chart) have gone a bit too far now, and they are in need of a technical "pullback." Such action may scare holders, but it is desirable and bullish. Other stocks (and there are hundreds of them) have formed the classic "head-and-shoulders" bottom or a potential of such a bottom. Xerox is typical, but note that we have only the left shoulder and the head (marked on chart). We still need another dip to form the right shoulder, and that would complete the bottom in this late-basing glamour stock.

What I am trying to show is that during this buying stampede many stocks are still forming bases while others are moving out and still others are consolidating their gains. But a study of hundreds of NYSE issues shows that important bases are forming in the great majority of issues. So many that one can make inferences about the market just from the sheer number of well-formed individual bases.

GOLDS: Many observers (particularly other advisories) have decided that I don't like gold anymore. That's not true. I operate on the thesis that my readers should have most of their funds where most of the action is. That has meant (for the past six months) cutting down on gold shares and since December moving into what was left of the pulverized stock market. I feel that those tactics were correct.

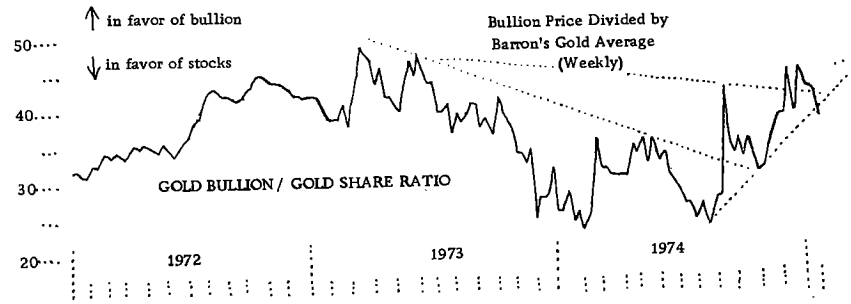
My studies of gold share momentum now indicate that momentum in the gold group has bottomed out. This does not guarantee an immediate boom in gold shares, but it does suggest that the group is consolidating and moving away from their extreme lows. Those who have my suggested 25% in gold-related items should hold these items (12% gold coins, 12% gold shares). Others who have limited funds may have sold out their golds and moved into the stock market. That's OK too, and so far that's where the profits have been. If the time comes to swap industrial shares for gold shares, I'll come out with it.

The chart of ASA (daily) should be instructive at this time. The stock split 2 for 1 and increased the dividend last week, but ASA reacted calmly. Note the series of declining peaks from the August high, the peaks of August, November, December, and now in February (they are numbered on the chart). ASA is approaching its major declining trendline. It will be important to see whether it can better it in the period ahead. Such a move would be bullish for gold shares in general (although not necessarily bearish for the market).



Why not bearish for the market, you ask? Because I think one factor in rising stock prices at this time is a fear of inflation and a movement of cash into assets (stock shares). If so, it becomes a question of which segment provides the better inflation protection, industrial or gold shares. My answer is, why guess, why argue, why offer uninformed opinions. Let's just watch relative strength. The top line on the chart shows the relative strength of ASA against the Dow. So far, the unassailable fact is that since August, 1974 the relative strength of ASA (gold) against the Dow (common stocks) has been in a downtrend. If that changes, my subscribers will know about it.

The next item of interest in the gold story is told in the second chart, the gold bullion to gold share ratio. After six months in favor of gold bullion (or coins) over gold shares, the ratio has reversed its trendline. It now indicates that the shares are outperforming the metal. Remember, this is not necessarily bullish or bearish for the gold group in general, but this chart does show preference. And preference is saying it's back to the shares.



LATE NOTES: On the latest dip this week, odd lotters sharply increased their selling to a 158 ratio of February 11. This means that they sold 158 shares for every 100 purchased, the heaviest rate of selling this year (and this with a minor dip of only three days and less than a third of a point in the A-D ratio!

Here is a point I would like all subscribers to remember. When stocks go up on big volume (which they have just done), the acid test is how well they hold when volume contracts. On the three days of February 7, 10 and 11, volume simmered down to the 16 million share level, the Dow declined but the A-D ratio hardly gave up anything. That was a bullish performance. In a bear market, high volume advances fall apart when volume contracts. Stocks can collapse even during very low volume days in a bear market, as we saw last year. This year, the action is different. Low volume, following a high volume advance in a bull market is usually a buying spot. In a bear market, it's a place to put out shorts.

LATE, LATE NOTES: (Written after close, Feb. 12). The Dow closed at 715.03, Transports at 160.05, both just under their January-February recovery peaks. The A-D ratio made a new recovery peak (see page 3). If Industrials and Transports break through their 717.85 and 161.05 levels, we'll have a powerful new "bullish signal." In the meantime, the buying stampede is fully intact with the A-D ratio the powerhouse of the market.... Just received my relative strength charts from Ray*Signals, 43 Lake Ave., Montrose, PA 18801, with their very accurate changes for the month. The Dairy Products and Savings & Loan groups have now turned bullish in relative strength. Good looking charts in Nat. Gypsum, Airco, Nabisco (old favority of mine), Fin. Federation, First Charter. Bearish relative strength charts for Homestake and Campbell Red Lake. Also bearish, Johnson & Johnson, Monsanto, Atl. Richfield.

You manage some $30 million, Steve. How do you pick stocks?

First, we decide this is the broad area, say, insurance, we want to be in and then we break the market down into 360 tiny sectors to determine what particular group we like. Do we want to be in the life insurance stocks or the casualty or the reinsurance stocks?

Why do you do it that way?

It's really dumb to get all wound up in individual stocks, because in the typical movement in an investment portfolio only 10% comes from stock selection.

And the rest?

About 65% comes from the upward move of the market itself, and 25% comes from industry or group selection. If you're looking at the institutional universe of 600 securities, to spend 90% of your time deciding if Exxon is better than Shell or Mobil is stupid.

This piece of an interview with Steve Leuthold (top fund advisor) with Piper, Jaffray & Hopwood (from Dun's Review) jibes with my view.